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No.

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1982

GRACE CAPPUCCILLI, DOROTHY CAPPUCCILLI, GERALD F. PADUANO and CAROLINE PADUANO,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

VICTOR CHINI, ESQ.
Attorney for Petitioners
Office and Post Office Address
915 State Tower Building
Syracuse, New York 13202
Telephone: (315) 422-7771

Of Counsel:

STANLEY R. GERMAIN
314 East Fayette Street
Syracuse, New York 13202
Telephone: (315) 422-4163

QUESTION PRESENTED — ISSUE ONE

Section 482[1] of the Internal Revenue Code of 1954 (26USC) and the Treasury Regulations thereunder authorizes the Commissioner to impute interest income on loans between controlled parties where a reasonable rate of interest has not been charged.

The question presented is whether the Commissioner may, under Section 482, impute interest income to CCP for the years 1970-1971-1972 on interest free loans and mortgage which it made to Stonehedge, a controlled related party, where CCP, received no imputed interest payment and where the payment of said interest to CCP from Stonehedge was prohibited by legal disability. The Second Circuit Court of Appeals affirmed the U.S. Tax Court in upholding the Commissioner's determination.

QUESTION PRESENTED — ISSUE TWO

The Second Circuit Court of Appeals in a landmark case upheld the Commissioner's right under Section 482 to impute interest income on interest free loans between related parties. *B. Forman Co. v. Commissioner,* 453 F.2d 1144 (2d Cir. 1972), cert. denied, 407 U.S. 934 (1972), rehearing denied, 409 U.S. 899 (1972).

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[1] Title 26 USCS Section 482 provides:

> "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

The question presented is whether the Commissioner's ten year retroactive application of Section 482 for the years 1970-71-72 to an interest free mortgage (of $1,075,000) executed in 1962 by CCP and Stonehedge is so arbitrary and oppressive as to violate the Petitioners' Fifth Amendment rights under the constitution.

QUESTION PRESENTED — ISSUE THREE

If the Court holds for the Commissioner on Issues One and Two, then: the question presented is whether the Commissioner's imputation of interest income to Paduano a partner of CCP (having three equal partners) at a time when CCP had interest free loans and mortgage due from Stonehedge and Seneca corporations which were totally owned by the other two partners, violates the Fifth Amendment rights of Paduano who has no interest in the corporate obligors.

QUESTION PRESENTED — ISSUE FOUR

The Petitioners who were assessed income taxes on imputed interest income (under Section 482) for the years 1967-1972, attempted to take a tax deduction in 1975 when the imputed interest income was deemed to be uncollectible.

The Tax Court denied Petitioners' deduction on the theory that any such deduction should be taken in 1976, (App. D, *infra*, 40a, 41a) a year not before the Tax Court. *Affirming the denial of the deduction on entirely different grounds*, the Second Circuit Court of Appeals held that Petitioners were seeking a double deduction. (App. A., *infra*, 6a).

The question presented is whether the denial of a tax deduction to Petitioners on uncollected and uncollectible imputed interest income on which taxes were assessed (and paid) constituted a violation of Petitioners' Fifth Amendment rights.

QUESTION PRESENTED — ISSUE FIVE

For purposes relevant to this issue, Section 1221 defines "capital asset" as

> "property held by the taxpayer (whether or not connected with his trade or business), but does not include —
>
> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business"
>
> Section 1221(1)

The United States Tax Court held that CCP recognized ordinary income and not capital gain on the sale of vacant land to Stonehedge in 1962 because CCP was a developer. This holding was based not on CCP's activities but on an erroneous principle of law, a joint venture theory, in which the Tax Court attributed Stonehedge's development activities to CCP. The Second Circuit Court of Appeals which did not embrace the Tax Court's joint venture theory, nevertheless, on an entirely different theory affirmed.

The question presented is whether the Second Circuit Court was justified in making a finding that CCP sold the subject property in the ordinary course of its trade or business under Section 1221(1) where the Tax Court's findings of CCP's lack of development activity were not clearly erroneous.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Victor Chini, attorney at law, on behalf of Grace Cappuccilli, Dorothy Cappuccilli, Gerald F. Paduano and Caroline Paduano, petitions for a writ of certiorari to review the judgment of the United States Second Circuit Court of Appeals in this case.

OPINIONS BELOW

The opinion of the Second Circuit Court of Appeals (App. A, *infra,* 1a-10a) affirming the United States Tax Court is reported at 668 F2d 138 (2d Cir. 1981), 82-1 USTC §9118, p. 83059. The United States Tax Court opinion (App. D, *infra,* 14a-45a) is reported at T.C. Memo 1980-347; 40 TCM 1084.

JURISDICTION

The opinion of the Second Circuit Court of Appeals was filed on December 29, 1981. The judgment of the Second Circuit Court of Appeals was also entered on December 29, 1981 (App. C, *infra*, 12a, 13a). The order denying rehearing en banc was entered on January 27, 1982 (App. B, *infra*, 11a). The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

STATUTE AND REGULATIONS

The relevant provisions of Sections 165, 166, 482, 6601 of the Internal Revenue Code of 1954 (26 U.S.C.), and of Treasury Regulations, Sections 1.166-1(a)(1) and (2), 1.166-1(c), 1.482-1(a)(3), 1.482-1(a)(6), 1.482-1(b)(1), 1.482-1(b)(3), 1.482-1(d)(1) and (2), 1.482-2(a)(1) (26 C.F.R.), and Revenue Procedure 65-17, Section 3.02, 4.02 1965-1 C.B. 833, are set forth at App. D., *infra*, 50a-66a.

STATEMENT

1. In 1954, brothers Peter and Rocco Cappuccilli formed a partnership with Gerald Paduano hereafter referred to as CCP. Each partner had a one-third interest in the partnership. (App. A, *infra*, 3a). The three partners had organized the Stonehedge Development Corporation (Stonehedge) in April of 1953 and subsequently organized the Seneca Sewerage Corporation (Seneca) in April of 1961. The stock of Stonehedge and Seneca was owned equally by the Cappuccilli brothers and Paduano until May 26, 1969 when Paduano retired his stock in the corporations and the Cappuccilli brothers became 100% owners of both corporations. Paduano remained a partner in CCP throughout all of the years in question. (App. A, *infra*, 3a).

All parties filed joint tax returns but, as the Cappuccilli's filed bankruptcy petitions in 1977, the deficiencies were assessed against their wives. (App. A, *infra*, 3a).

2. In February of 1958 the partnership, CCP, began to acquire options to buy farm lands adjoining a tract of land developed by Stonehedge in 1955. (Jt. Ex. 19-S; R. 3) (App., *infra*, 64a)

In 1960-1962, CCP exercised the options that it had acquired and purchased a number of individual parcels at a cost of $445,723.00 to assemble a tract known as Seneca Knolls farms. CCP made no attempt to improve or subdivide the tract and subsequently (after a holding period in excess of six months)[2] sold the tract to Stonehedge for a sales price of $1,570,327.39 consisting of assumption of mortgages, cash and two promissory notes, one for $81,000.00 at six percent interest and one noninterest bearing mortgage note of $1,075,000.00. (App. A., *infra*, 3a, 4a; App. D, *infra*, 17a-19a).

On April 15, 1961, CCP purchased a different parcel of land, the Preston Farm, from Stonehedge for $25,000.00 and resold it the next day to Seneca for $40,000.00 which included a promissory note for $25,000.00 at six percent interest. (App. A., *infra*, 4a).

3. Neither Stonehedge nor Seneca paid CCP any interest on their respective mortgages. (App. D, *infra*, 21a).

> Zoning problems prevented Stonehedge from developing the land. From 1970 to 1975, Stonehedge borrowed $500,000.00 from the Merchants National Bank & Trust Co., on the security of a pending eminent domain claim against New York State, and in 1972 the corporation sold land for $223,756, paying the proceeds to CCP. But from 1970 to 1972, CCP had to advance cash to Stonehedge to keep the corporation going. Stonehedge's debt to CCP for these advances once totalled $120,000. Stonehedge managed to repay these advances, but never paid any interest on them. In 1972, Stonehedge reconveyed part of the Seneca Farms to

[2]Including the option periods (since 1958) CCP had effective control on all farms for an average of 43 months. (Jt. Ex. 19-S; R. 3) (App., *infra*, 64a)

CCP and CCP foreclosed on the remainder, in full satisfaction of Stonehedge's obligations to the partnership. Because CCP had received payments on the notes while Stonehedge was in possession of the land, CCP recognized gain to the extent of those payments — $482,577 — upon repossession under I.R.C. Sec. 1038. CCP reported this gain as capital gain.

(App. A, *infra*, 4a).

4. The Commissioner concluded that the lack of interest recognized by CCP on the mortgages to Stonehedge and Seneca understated the true income of the partnership and, pursuant to Section 482 of the Internal Revenue Code, allocated some $325,718.90 in "interest income" to CCP for 1967-1969. The Commissioner simultaneously credited the corporations with an interest deduction in the same amount and the allocation was upheld in *Paduano v. Commissioner*, 538 F.2d 312 (2d Cir. 1975), *cert. den.*, 425 U.S. 992 (1976). (App. A., *infra*, 4a).

In 1975, Stonehedge merged with Community Technology, Inc. (CTI), which filed a Chapter XI bankruptcy petition in 1976. CCP filed a claim for $325,718.90 in interest income from Stonehedge as allocated by the Commissioner for the years 1967-1972. In February 1978 the Bankruptcy Court denied the claim, holding that the Commissioner's allocation imposed no obligation under New York law, on CTI to pay interest to CCP. (App. A., *infra*, 5a).

In its amended partnership return for 1975, signed August 13, 1976, CCP claimed a bad debt deduction for the interest allocated for 1967-1969 and subsequently filed amended returns for 1975 and refund claims to carry back the net operating loss to the taxable year 1972. (App. A, *infra*, 5a).

5. The Commissioner denied the 1967-1969 deduction and refund and allocated another $132,088.70 in interest income from Stonehedge and Seneca for 1970-1972. The Commissioner also determined that CCP's gain on the foreclosure and

repossession of land from Stonehedge was ordinary income and not capital gain. (App. A, *infra*, 5a).

6. The Tax Court sustained the Commissioner's determinations and the Second Circuit Court of Appeals affirmed the decision of the Tax Court, under different theories holding:

a) For the years 1967-69; no bad debt deduction was allowed to CCP on interest income of $196,380 which was imputed from Stonehedge and upon which CCP had paid a tax, and which interest it could not collect.

b) For the years 1970-72; the Commissioner could impute interest income of $129,339 to CCP from Stonehedge; also CCP could not claim a bad debt loss for that amount even though said interest was uncollectible.

c) CCP's gain on repossession of land from Stonehedge was ordinary income, not capital gain. (App. A, *infra*, 3a).

REASON FOR GRANTING CERTIORARI ON ISSUE ONE

The holdings of the Courts below in imputing interest income where a legal disability exists as to collection appear to be in direct conflict to the holding of this Court in *Commissioner v. First Security Bank of Utah*, 405 U.S. 394, (1973) which held that:

> Since the taxpayers (banks) received no premium insurance income, and were legally prohibited by law from receiving any such income, the Commissioner's allocation to the taxpayers under Sec. 482 was not warranted.

As Justice Powell of this Court said:

> "We know of no decision of this Court wherein a person has been found to have taxable income that he did not receive and that he was prohibited from receiving. In cases dealing with the concept of income, it

> has been assumed that the person to whom the income was attributed could have received it. The underlying assumption always has been that in order to be taxed for income, a taxpayer must have complete dominion over it."

405 U.S. 394, 403.

In the instant case, the sale by CCP to Stonehedge providing for an interest free mortgage took place ten years prior to the Second Circuit Court's decision in, *B. Forman Co. v. Comm.*, 453 F.2d 1144 (2d Cir. 1972), cert. den. 407 U.S. 934 (1972), which upheld the Commissioner's authority to impute interest on loans between related parties. Prior to the *Forman* case, *(supra)*, and at the time of the transactions relevant to the case at bar, a long series of cases held that the Commissioner could not "create" income that was not actually or constructively received.

In fact, prior to the *Forman* case in 1972, *there was neither legal nor theoretical justification* for the payment of interest on a non-interest bearing loan between related parties. *Mertens, Law of Federal Income Taxation* Vol. 7 Sec. 38.63 at p. 160; See also: *Forman, (supra)* 453 F.2d at 1144, 1155-1156.

In 1978 CCP filed a claim in the Bankruptcy Court in an attempt to recover the interest that had been imputed by the Commissioner from Stonehedge in the amount of $325,718.90 for the years 1967-1972. The Bankruptcy Court denied CCP's claim on the ground that no liability existed under New York law and held that CCP was prohibited, by law, from collecting the imputed interest. (App. E, *infra*, 46a-49a).

Since the Commissioner argued in the Bankruptcy Proceedings (of CTI) that no valid obligation was created by the income allocation under Section 482, it is clear that the imputation of interest income under Section 482 creates an uncollectible debt and results in a tax on proceeds that would not, and could not, have been paid.

In *Corn Exchange Bank v. U.S.*, 37 F.2d 34 (2d Cir. 1930), (involving an accrual basis taxpayer), the Court said at page 34:

> "When a tax is lawfully imposed on income not actually received, it is upon the basis of a reasonable expectancy of its receipt, but a taxpayer should not be required to pay a tax when it is reasonably certain that such alleged accrued income will not be received and when in point of fact it never was received."

In *Commissioner v. First Security Bank of Utah, supra,* this Court held that the Commissioner could not allocate insurance commission income under Section 482 to banks which had not received the income and were prohibited by federal banking law from receiving said commissions. This same principle has been extended by other courts and applied to cases where, as here, taxpayers were precluded from collecting imputed or "phantom" income due to prohibitions in state laws.

In *Delta Life Insurance Company v. U.S.*, 363 F. Supp. 410 (1973) the court held that where a life insurance company was required to maintain certain reserves under Louisiana law, the IRS is precluded from imposing a smaller reserve which would result in higher taxes. The *Delta* court cited *First Security Bank of Utah, supra,* stating:

> "The bank simply lacked the requisite power to receive the income. Likewise, Delta lacked the power under state law to maintain a smaller reserve." (363 F. Supp. at 415)

In *Owen W. Bunker,* T.C. Memo 1979-174 (1979), the Commissioner attempted to tax a bank on a certain stock gain, based on an argument that the bank was the real owner of the stock. The Tax Court held that since the state banking law prohibited the bank from owning the stock in question, the Commissioner could not tax the bank on the stock gain.

In *Bank of Coushatta v. U.S.*, 650 F.2d 75 (5th Cir. 1981), the Fifth Circuit held that, where a bank transferred its credit

insurance operation to individual agents based on its good faith belief that it would have been illegal for the bank to continue to earn and receive insurance commission income, the Commissioner could not allocate commission income to the bank under Section 482 because the bank did not actually, or constructively receive the income. The Court responded to the government's argument that the reasoning in the *First Security Bank of Utah* case *(supra)* was limited to cases where it would be *illegal* for the taxpayer to receive the income stating:

> "The Supreme Court clearly did not hold that a showing that it would be illegal to receive commissions is essential for a plaintiff to prevail in a similar situation. Rather, the fact that the banks could not legally have received the commissions was cited as proof that the funds were not diverted away from them by the holding company. The issue in this case is whether Coushatta received the commission actually or constructively as income."
>
> 650 F.2d 75, 77.

In *U.S. v. Basye*, 410 U.S. 441 (1973) this Court held that the reasoning in *First Security Bank of Utah, supra*, does not apply where taxpayers were contracting parties that agreed to deflect their income to a retirement trust for their benefit.

The critical factor distinguishing the *Basye* case, *(supra)*, from the case at bar is that while the taxpayers in *Basye* attempted to defer the taxation of their earnings, the taxpayers in the instant case had no real income to deflect or defer. The alleged income in the case at bar is comprised solely of phantom interest created by the Commissioner and then allocated to CCP. Also, prior to *Forman, supra*, the taxpayers were conducting business within the legal framework of state law and federal tax laws.

As Justice Powell of this Court stated in the *First Security Bank of Utah, supra:*

> "The 'complete power' referred to in the regulations hardly includes the power to force a subsidiary to violate the law."
>
> 405 U.S. at 405

This is precisely what the Commissioner is requiring of Stonehedge. If prior to *Forman* (1972) *supra*, Stonehedge had deducted interest on its tax returns for those years, Stonehedge and its officers would have violated not only state law — but also the Federal Income Tax Laws — because its returns would have been fraudulent.

It is clear from the foregoing that the holding of the Courts below directly conflicts with the principle enunciated by this Court in *Commissioner v. First Security Bank of Utah, (supra)*. The extent of the Commissioner's ability to create, allocate and then tax income that was uncollected and uncollectible raises numerous questions of far-reaching consequences and should be addressed and clarified by this Court so that this area of the income tax law may be administered more fairly, uniformly and equitably.

REASON FOR GRANTING CERTIORARI ON ISSUE TWO

The treasury regulations authorizing the Commissioner to allocate interest income based on loans between related parties were not *proposed* until four years after the sale by CCP (1962) to Stonehedge and were not adopted until 1968, some six years after the transaction in issue. Treas. Regs. Section 1.482-2(a)(1); Section 1.482-2(a)(2).

Even after the adoption of the aforementioned regulations in 1968 it was another four years before the Second Circuit Court's decision in *B. Forman Co. v. Comm., (supra)*, in 1972 upheld the Commissioner's authority to impute interest on loans between related parties where no interest rate had been expressly stated.

This Court in several cases has upheld the retroactive application of the income tax laws involving periods of twelve months or less, as not violating the due process clause of the Fifth Amendment. See *U.S. v. Darusmont*, 449 U.S. 292 (1981) reversing and remanding District Court 80-2 USTC §9671, p.85208, and cases cited therein.

In that case this Court stated:

> "This 'retroactive' application apparently has been confined to short and limited periods required by the practicalities of producing national legislation. We may safely say that it is a customary congressional practice."

However, petitioners are of the opinion that their situation is analogus to that of the individual referred to by Judge Hand, who "has no reason to suppose that any transactions of this sort will be taxed at all". *Cohan v. Commissioner*, 39 F.2d 540, 545 (2d Cir. 1930).

It is clear from the facts in this case however, that unlike the taxpayers in *Cohan (supra)*, the taxpayers herein had no reason to suppose that the transactions entered into in 1961-1962 would, or could, be taxed. It was not until after *Forman, supra*, some ten years after the transactions, that the novel idea that the Commissioner could create and impute interest income not actually charged by related parties was accepted.

The Commissioner's retroactive application of Section 482 in this case constitutes such an unduly harsh, oppressive and arbitrary assessment of the taxpayers as to amount to a confiscation in violation of their rights to due process under the Fifth Amendment. *Heiner v. Donnan*, 285 U.S. 312 (1932); *Nichols v. Coolidge*, 274 U.S. 531 (1927).

REASON FOR GRANTING CERTIORARI ON ISSUE THREE

Section 482 was designed to prevent tax avoidance between related business entities and to treat related parties as non-related parties in similar business transactions. With respect to the time period involved (1970-71-72) it cannot be said that Paduano was related in any way to the corporate obligors (Stonehedge and Seneca).

There is no language in that statute, the regulations or the legislative history of Section 482 to warrant the holding that a party who derived no economic benefit on an interest free loan, must nevertheless, because of his status as a partner, at the time that the loan was made, be charged with income taxes.

As Justice Powell of this Court stated:

> "We know of no decision of this Court wherein a person has been found to have a taxable income that he did not receive . . . In cases dealing with the concept of income it has been assumed that the person to whom the income was attributed could have received it. *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 at 403 (1972).

In his concurring opinion in the Court below, Judge VanGraafeiland raised the constitutionality of charging income tax to Paduano, stating:

> "In May 1969, Mr. Paduano relinquished all of his interest in Stonehedge Development Corporation and Seneca Sewerage Corporation. The only evidence presented in the Tax Court indicated that, although Paduano remained a nominal partner in CCP, he in fact retired from active participation in that partnership. Despite these undisputed facts, Mr. and Mrs. Paduano have been held liable to pay a tax on nonexistent income allocated from the corporations to the partnership and which, of course, the Paduanos never received.

> When actual partnership income is involved, the law is clear that each partner must pay a tax on his distributive portion of that income. *United States v. Basye*, 410 U.S. 441, 448 (1973). However, "(t)hat which is not in fact the taxpayer's income cannot be made such by calling it income." *Hoeper v. Tax Commission*, 284 U.S. 206, 215 (1931). Taxable income contemplates the existence of an economic benefit which is subject to the dominion and control of the taxpayer. *Commissioner v. Kowalski*, 434 U.S. 77, 83 (1977); *Commissioner v. First Security Bank*, 405 U.S. 394, 403 (1972). Because the Paduanos had no interest in or control over the corporations during the taxable years in question and derived no benefit whatever from the interest-free loans to those entities, the allocations of income from the corporations to the Paduanos has constitutional implications which are bothersome. Although courts look upon tax legislation with an indulgent eye, a levy which is so arbitrary and capricious as to amount to confiscation may be held to violate the Fifth Amendment. *Heiner v. Donnan*, 285 U.S. 312, 326 (1932); *Nichols v. Coolidge*, 274 U.S. 531, 542 (1927).
>
> (App. A, *infra*, 8a, 9a)

The application of Section 482 in this instance constitutes an unwarranted and unreasonable interpretation of that statute, and a violation of Mr. Paduano's constitutional rights under the Fifth Amendment. Cf. *U.S. v. Vogel Fertilizer Co.*, 82-1 USTC §9134, p.83116 (S.Ct. 1982).

REASON FOR GRANTING CERTIORARI ON ISSUE FOUR

The Courts below disallowed the taxpayers the right to take a deduction for the imputed interest income that was neither collected nor collectible and this Court should grant certiorari to review this finding for the following reasons:

1) The Second Circuit Court of Appeals affirmed on a different theory than the Tax Court. *Reisman v. Caplin*, 375 U.S. 440, (1964).

2) The Second Circuit Court applied an incorrect principle of law (its double deduction theory) in that it ignored the separate entities of Petitioners (CCP) and Stonehedge. This Court recognized that a corporation is a separate taxable entity. *Moline Properties, Inc. v. U.S.*, 319 U.S. 436 (1943). It is well settled that in determining the trade or business of a taxpayer, the business activities of a closely held corporation will not be attributed to the taxpayer absent a showing of exceptional circumstances. See, *Burnet v. Clark*, 287 U.S. 410 (1932); *Jarvis v. Commissioner*, 32 T.C. 173 (1959); *Gordy v. Commissioner*, 36 T.C. 855 (1961).

3) The Second Circuit Court's analysis of Section 482 ignores the intent of Treas. Regs. Section 1.482-1(d)(2) and Rev. Proc. 65-17 Sections 3.02, 4.02, 1965-1 CB. 833 as to reciprocal entries required under a Section 482 allocation.

4) The denial of a tax deduction in this instance constitutes an arbitrary, unwarranted, and discriminatory application of the Commissioner's authority under Section 482 and violates Petitioners' Fifth Amendment rights. *Heiner v. Donnan, supra; Nichols v. Coolidge, supra.*

5) Because there has been an increasing use by the Commissioner of Section 482, and *because the question of a tax deduction after the application of Section 482 has never been decided by this Court*, the resolution of this issue is necessary for the proper administration of the tax laws. *U.S. v. Stapf*, 375 U.SS. 118, (1963) rehearing denied, 375 U.S. 981.

TAX COURT'S THEORY

The Tax Court rejected CCP's bad debt claim for either 1972 or 1975 on the theory that if a debt arose (from a Section 482 allocation) it did not come about until 1976 (App. D, *infra*, 40a). However, the court noted that even if there was no debt that Petitioners may be entitled to a loss, for 1976 (citing *Tharp v. Commissioner*, T.C. Memo 1972-10; *Corn Exchange Bank, supra*) (App. D, *infra*, 41a, Fn. 37).

In denying the deduction the Tax Court reasoned that the underlying tax liability as well as the interest obligation was contingent until a final decision in the *Paduano* case. (App. D, *infra*, 41a). Under the Court's reasoning, no interest should be charged by the Commissioner for the years 1967-69 except from the date the tax liability became final, in 1976; *but this is not the case.* Interest on an income tax liability or deficiency runs from the due date of the income tax returns for the years in issue. Section 6601; *Morton-Norwich Products, Inc. v. U.S.*, 602 F.2d 270 (Ct. Cl.1979). The "contingent liability" cases cited by the Court are inapposite since they do not support the position that an income tax liability becomes a fixed liability when a final decision has been rendered, although the underlying adjustments relate back to the tax years in issue.

A consistent and logical theory would hold that in Section 482 cases, the imputed interest income, interest expense, and the income tax consequences take effect simultaneously and retroactively (from the date of the final determination). The Commissioner apparently recognizes that the interest obligation arises at the same time that the interest income is imputed, because under Revenue Procedure 65-17, Section 4.02 1965-1 C.B. 833, he permits the taxpayer to issue promissory notes in payment of the interest obligation (which results from a Section 482 allocation) in order to avoid a double tax effect in certain situations. Also under Treasury Regs. Section 1.482-1(d)(2) correlative adjustments are required as to the related parties *at the time interest is imputed.*

In *Pitchford v. Commissioner*, T.C. Memo 1975-75, the Commissioner conceded, (solely for purposes of that case), that a Section 482 allocation should not be made in situations where the financial condition of the related party obligor was such that an accrual of such interest income would not have been justified on interest bearing loans involving non-related parties. By this concession, the Commissioner recognized that the

interest debt exists simultaneously with the imputation of interest.

Subsequent to the *Pitchford* case, the Tax Court, in *Hennessey v. Commissioner*, T.C. Memo 1977-122, again *considered the collectibility of an interest obligation*, and again did so for the same years in *which the Commissioner imputed the interest income*. The *Hennessy* court thus recognized that the interest income and the related interest obligation should be considered during and for the tax years in issue.

Petitioners argued in the Tax Court and on appeal that interest should not be imputed if there is no reasonable expectation of collection. The Tax Court found and the Second Circuit agreed that there was a reasonable expectation of collection. (App. A, *infra*, 7a). This holding necessarily implies that there was a pre-existing (or a simultaneous) debt which was in fact collectible.

Accordingly, it should necessarily follow that if there was an interest debt due (under Section 482) and if that interest is not collected and a tax was previously assessed, then a tax deduction should be permitted either under Section 165 (loss) or Section 166 (bad debt).

DOUBLE DEDUCTION THEORY

Notwithstanding, the Tax Court's implied admission of some tax relief to CCP for paying income tax on funds which CCP could not receive, the *Second Circuit Court under a theory which was not briefed or argued by the government*, and *on an entirely new and unprecedented theory, held that no deduction at all was permissible to CCP. That Court reasoned that petitioners were attempting to take a double deduction* because the Commissioner had already allowed an interest deduction to Stonehedge and Seneca who are not the taxpayers in this case. (App. A, *infra*, 6a) This *"double deduction" theory is incorrect as a matter of law.*

Either Stonehedge and CCP (and Seneca and CCP) are separate entities for tax purposes or they are not. If they are, and the lower Courts held so for imputing interest income, then consistency and fairness requires that they be treated as such for all tax consequences.

In denying a deduction for bad debt or business loss to CCP, the Second Circuit Court had these remarks:

> "Such a deduction was granted by the Commissioner to Seneca and Stonehedge. Thus *taxpayers seek* double deductions for Sec. 482 allocations. Neither the law nor common sense supports such an outcome." (emphasis added) (App. A, *infra*, 6a)

The appellants' position is that the Court's reasoning concerning a "double deduction" or "windfall" profits theory clearly and unfairly ignores the fact that Stonehedge and CCP and Seneca and CCP are separate entities.

Although the corporations obtained a deduction for interest expenses, *CCP received no deduction*. Stonehedge and Seneca are not the taxpayers in this case; the taxpayers before the Court are the partners (and their wives) of CCP. Consequently for the Second Circuit Court to allege a double deduction to the taxpayers, it must, of necessity, group all the corporate entities and CCP as one taxable entity. Under this reasoning, however, there would have been no Section 482 allocation made in the first place.

This Court recognized that a corporation is a separate taxable entity. *Moline Properties, Inc. v. U.S., supra*. Also, it is well settled that in determining the trade or business of a taxpayer, the business activities of a closely held corporation will not be attributed to the taxpayer absent a showing of exceptional circumstances. See, *Burnet v. Clark, supra; Jarvis v. Commissioner, supra; Gordy v. Commissioner, supra*.

The Second Circuit Court in this case as well as in its *Forman* decision (*supra*, 1972) recognized that the lender and borrower

were separate viable entities for purposes of a Section 482 imputation of interest, but when the lender attempts to claim a tax deduction on the uncollected imputed interest that court in denying the deductions inconsistently holds they are not separate entities.

Nor can it be argued that the subsequent events which allow CCP (under the tax law) to take a deduction for uncollected interest, frustrate the tax law or result in any sort of windfall or double deduction because the same principle also applies to taxpayers having net operating losses (Section 172) or capital losses (Section 1212) which are allowed to be carried back to earlier years.

The tax law also allows bad debt losses (Section 166 of the Code) and ordinary business losses. (Section 165 of the Code). These tax relief measures are allowed to non-related parties and should be allowed to related party transactions in this instance.

An example to point out the inconsistency of the double deduction theory follows:

Suppose that CCP had been on an accrual accounting basis and that it had charged interest income on the Stonehedge mortgage. At year end, CCP would have accrued interest income, and the partners would have paid income taxes on the accrued interest income. Suppose at a later date Stonehedge never having paid the accrued interest to CCP went bankrupt. Under the tax law CCP would have been entitled to take a business bad debt deduction under Section 166 of the Code.

Why should the fact that the Commissioner imputed interest income (which effectively puts CCP on an accrual basis for that purpose), to CCP under Section 482 change that result. Concerning collection of the imputed interest, the Second Circuit Court stated:

> "Had CCP wished to receive payment from the corporations reflecting the allocation of income, the

> partnership could have done so only upon application to the Commissioner and only if the Commissioner determined the interest free loans were not intended to avoid taxes. Rev. Proc. 65-17 Sections 3.02, 4.02, 1965-1 C.B.833." (App.A, *infra*, 6a)

The facts of this case make it clear, however, the Petitioners did not structure the transactions in question to avoid taxes. Most of the imputed interest involved here arose from a non-interest bearing mortgage which was transacted in 1962. This was eight years prior to the adoption of Treasury Regs. Section 1.482-2 (concerning interest free loans) and ten years prior to the *Forman* decision which upheld the Commissioner's Section 482 allocation in related party interest free loans. Before *Forman*, the law was to the contrary and no such allocation could have been made.

In fact, "Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the District Director to apply such provisions". Treas. Regs. Section 1.482-1(b)(3).

Thus assuming that Stonehedge had been in a higher tax bracket than the partners of CCP, if Stonehedge had taken an imputed interest deduction, (prior to *Forman, supra*) on the interest free mortgage (in order to reduce the overall taxes), Stonehedge and its officers would be filing fraudulent income tax returns.

It is submitted, based on the foregoing that the "double deduction" theory is illogical and contrary to established principles of law.

Compare *Mortiz v. Comm.*, 469 F.2d 466, (10 Cir. 1972) which held that an income tax deduction based on sex classification "is subject to scrutiny under equal protection principles . . . as part of due process under the Fifth Amendment." (In that case spinsters were allowed deductions for dependent care but not bachelors).

Compare also, a recent case decided by the United States Circuit Court of Appeals for the District of Columbia in which that Court struck down a law granting tax exempt status to veteran's groups but denied exemption to "other charitable and educational groups who conduct lobbying activities". That Court stated:

> "Congress has violated the equal protection guarantees of the Constitution" by granting different tax treatment to these groups. *Taxation with Representation of Washington v. Regan*, 82-IUSTC ¶9272, p. 83611 (D.C. Cir. 1982)

Neither the Commissioner nor the Second Circuit Court cited any authority to suggest that Congress intended that related parties (under Section 482 transactions) should be penalized and treated more harshly than non-related parties in similar transactions. The Second Circuit's holding in this instance is an unwarranted and unreasonable interpretation of the application of Section 482. cf. *U.S. v. Vogel Fertilizer Co., supra.*

Also, the denial of a deduction to CCP amounts to a confiscation cf. *Heiner v. Donnon, supra,* and is an obvious gross injustice. *Nichols v. Coolidge, supra.*

Based on the foregoing, it is clear that CCP was entitled to a deduction for either a business bad debt (Section 166) or an ordinary loss (Section 165) equal to the adjusted basis of the uncollected imputed interest, (Section 166(b)).

The denial of a deduction would constitute a violation of Petitioners' Fifth Amendment rights under the Due Process Clause.

REASONS FOR GRANTING CERTIORARI ON ISSUE FIVE

In denying capital gains treatment to Petitioners on their sale (through CCP) in 1962 of vacant land to Stonehedge Corporation, a related entity, the Second Circuit Court of Appeals relied on a different theory than the United States Tax Court. (App. A, *infra*, 3a, 7a, 8a) *Reisman v. Caplin, supra.*

The Tax Court did not enumerate in its findings the various factors set forth in *Gault v. Commissioner*, 332 F2 94 (2d Cir. 1964) for determining whether CCP sold the subject property to Stonehedge in the ordinary course of its business, under Section 1221(1) which are:

> "(1) the frequency, number and continuity of sales; (2) Subdivision, plotting, and other improvements or developments tending to make the property more marketable; (3) the extent to which the taxpayer is engaged in sales activity; (4) the length of time the property has been held; (5) the substantiality of the income derived from the sales, and what percentage that is of the taxpayer's total income; (6) the nature of the taxpayer's business; (7) the taxpayer's purpose in acquiring and holding the property; (8) the extent of the sales promotional activities such as advertising; (9) the listing of property directly through brokers."

332 F.2d 94 at 96.

On the contrary Judge Tannenwald of the Tax Court found that:

> *"CCP would make no efforts to improve or subdivide the parcel* but would subsequently sell it, at a profit, to Stonehedge, which . . . (would then develop the property)". (App. D, *infra*, 17a) emphasis supplied.

The Tax Court conceded that CCP and Stonehedge were separate taxable entities and that CCP's acquisition, holding and subsequent sale of the subject property was separate from

the development activities later undertaken by Stonehedge. Nevertheless, the Tax Court held, that:

> "CCP can not be permitted to insulate itself from the acts of an entity (Stonehedge) whose efforts are so closely related to its own; the supplier of developable land may be regarded as a joint participant with the builder in an integrated real estate development business." (Citations omitted). (App. D, *infra*, 43a)

The Tax Court concluded that CCP and Stonehedge were "joint participants" in a real estate development venture and that CCP was, therefore, "in the trade or business of land development and sales at the time the Seneca Knolls properties were sold." (App. D, *infra*, 44a).

It is well settled that in determining the trade or business of a taxpayer, the business activities of a closely held corporation will not be attributed to the taxpayer absent a showing of exceptional circumstances. See, *Burnet v. Clark, supra; Jarvis v. Commissioner, supra; Gordy v. Commissioner, supra.*

In *Gordy, (supra)*, the Tax Court considered facts similar to those in the case at bar and held that the taxpayer's gain on the sale of land to a controlled corporation in the real estate development business constituted capital gain and not ordinary income. The Tax Court in *Gordy* stated:

> "Respondent recognizes no distinction between a taxpayer holding property for sale to his customers and a taxpayer holding property for sale to his controlled corporation engaged in selling such property to its customers."

36 T.C. 855 at 859-860. The *Gordy* Court, citing *Burnet v. Clark, (supra)*, held, that the taxpayer's business and the business of the real estate development corporation were separate and distinct and that, as long as the corporation was a viable entity and could not be regarded as the taxpayer's alter

ego or agent, the corporation's development activities could not be attributed to the taxpayer.

It is undisputed that throughout the years in question Stonehedge was a viable business entity and in no sense the alter ego of CCP. *The primary point of contention here thus concerns the Tax Court's finding that Stonehedge's activities could be imputed to CCP because the entities were engaged in a joint venture.* The cases cited by the Tax Court in support of this finding are clearly distinguishable from the case at bar both in principle and on the facts. This is supported by the fact that neither the government in its argument to the Second Circuit Court, nor that Court itself, relied on the Tax Court's joint venture theory. (App. A, *infra*, 8a).

If the Tax Court on the facts presented could have found CCP a developer based on CCP's own activities (and not the activities of Stonehedge), it would seem unreasonable and unwarranted for that Court also to rely on the joint venture theory. Since the trial Judge did not, on the facts pertaining to CCP alone, hold that CCP was a developer, and since the facts pertaining to the lack of CCP's development activity and lack of significant sales activity were not clearly in dispute, it is submitted that the Second Circuit Court's holding was not justified by the facts and is erroneous.

CONCLUSION

The petition for writ of certiorari should be granted.

VICTOR CHINI, ESQ.
Attorney for Petitioners

Stanley Germain, Jr., Esq.
of Counsel

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